BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP6/14

Clawback

March 2014

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Please address any comments or enquiries to:
Email: clawback@bankofengland.co.uk by 13 May 2014.

1 Introduction

1.1 This chapter sets out a proposal on extending the Remuneration Code[(1)] to require all PRA-authorised firms to amend employment contracts to be able to apply clawback to vested variable remuneration on a group-wide basis.

1.2 The proposal seeks to advance the PRA's general objective to promote the safety and soundness of firms.[(2)] The Remuneration Code aims to ensure that firms have risk-focused remuneration policies, which are consistent with and promote effective risk management. This includes eliminating incentives towards excessive risk-taking, encouraging sound risk management, and aligning employee incentives with the longer-term interests of the business, taking account of the potential for financial risks to crystallise over long timeframes.

1.3 Proposed Remuneration Code rule changes are presented in Appendix 1.

2 Summary of the proposal

2.1 The PRA proposes to require firms to amend employment contracts to enable them to apply clawback to vested variable remuneration. The amendment to the Remuneration Code also clarifies the PRA's position and expectations on the application of clawback.

2.2 In line with the existing Remuneration Code requirements on malus, a firm should as a minimum be able to clawback vested variable remuneration when:

(a) there is reasonable evidence of employee misbehaviour or material error; or

(b) the firm or the relevant business unit suffers a material downturn in its financial performance; or

(c) the firm or the relevant business unit suffers a material failure of risk management.

2.3 The proposed rule will come into force on 1 January 2015. The PRA expects firms to amend employment contracts to allow for the application of clawback to all vested awards up to six years after vesting.

2.4 The PRA also expects firms to take all reasonable steps to amend employment contracts to reflect awards made prior to 1 January 2015, but which vest after that date, again subject to a limit of six years after vesting.

2.5 Six years is the maximum time period proposed in line with the statute of limitations for contracts.

2.6 As in the case for malus, clawback should not be limited to employees directly culpable of malfeasance. For example, in cases involving a material failure of risk management or misconduct, firms should consider applying clawback to those employees who:

(a) could have been reasonably expected to be aware of the failure or misconduct at the time but failed to take adequate steps to promptly identify, assess, report, escalate or address it; or

(b) by virtue of their role or seniority could be deemed indirectly responsible or accountable for the failure or misconduct, including senior staff in charge of setting the firm's culture and strategy.

Questions

The PRA invites comments on the propositions set out above, particularly with respect to:

- The proposal that the grounds for applying clawback should be as wide as the grounds for malus.
- The proposal to limit the application of clawback to a period of six years from the point of vesting.

3 Cost-benefit analysis

3.1 Remuneration policies that incentivise excessive risk-taking and short-termism have been identified as a contributing factor to the financial crisis. The proposal put forward in this consultation aims to promote the general objective of the Remuneration Code, which is to ensure firms have remuneration policies that foster sound risk management and discourage excessive risk-taking and short-termism.

3.2 Changes to remuneration policies have traditionally been complicated by 'first-mover disadvantage'. That is, firms are afraid of losing key staff to competitors if their revised remuneration policies are seen as less favourable than other firms'. Therefore, there is a possible role for the regulator to help ensure a greater degree of co-ordination and consistent application across the industry.

3.3 The impact of the proposal will depend on the specific criteria and time period in which the application of clawback is to be applied, as well as how likely it is that they can be enforced.

(1) The Remuneration Code (The Senior Management Arrangements, Systems and Controls (SYSC) 19A sourcebook of the PRA's Handbook) sets out the standards that banks, building societies and designated investment firms have to meet when setting pay and bonus awards for their staff. It aims to ensure that firms' remuneration practices are consistent with effective risk management. Any amendments will have no impact on the PRA's existing approach to proportionality: www.bankofengland.co.uk/publications/Documents/other/pra/policy/2013/remunerationstandardslss8-13.pdf.
(2) Section 2B(1) and 2B(2) of FSMA 2000.

3.4 There will be costs associated with amending employment contracts, including the need to renegotiate terms with staff. However the PRA does not expect these costs to be significant.

3.5 Where the proposal is successful in clawing back vested variable remuneration, firms will benefit from recouping variable pay. In addition, requiring firms to be able to apply clawback to the vested variable remuneration could lead to longer vesting periods of executive remuneration, which could discourage short-termism.

3.6 If this proposal is successful in achieving its aims of curbing excessive risk-taking and short-termism, it will help the PRA to achieve both its objective to promote the safety and soundness of firms and its objective to facilitate competition.

4 Statutory obligations

4.1 This proposal to enhance incentives for sound risk management is consistent with the PRA's objective to promote the safety and soundness of firms.(1)

4.2 The PRA has a statutory requirement to consider how the proposal may affect mutuals.(2) The proposal will apply to all firms, including mutuals which, the PRA considers, are unlikely to be affected any differently from other firms.

4.3 The PRA considers that the proposal is in line with the Regulatory Principles.(3) They ensure that the regulator exercises its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons by welcoming industry views on significant elements of the proposal.

4.4 The PRA has considered equality and diversity issues but has not identified any impacts arising from the proposal.

(1) Section 2B(1) and 2B(2) of FSMA 2000.
(2) Section 138K(2) of FSMA 2000.
(3) Section 3B of FSMA 2000.

SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS (REMUNERATION CODE – CLAWBACK) INSTRUMENT 2014

Powers exercised

A. The Prudential Regulation Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137G (The PRA's general rules);
(2) section 137H (General rules about remuneration); and
(3) section 137T (General supplementary powers).

B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Pre-conditions to making

C. In accordance with section 138J of the Act (consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

Commencement

D. This instrument comes into force on [Date].

Amendments to the Handbook

E. The Senior Management Arrangements, Systems and Controls sourcebook (SYSC) is amended in accordance with the Annex to this instrument.

Notes and Guidance

F. In the Annex to this instrument, the "notes" (indicated by "**Note:**") are included for the convenience of readers but do not form part of the legislative text.

Citation

G. This instrument may be cited as the Remuneration Senior Management Arrangements, Systems and Controls (Remuneration Code - Clawback) Instrument 2014.

By order of the Board of the Prudential Regulation Authority
[*date*]

Annex

Amendments to the Senior Management Arrangements, Systems and Control sourcebook (SYSC)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

SYSC 19A Remuneration Code

…

19A.3.51 R A *firm* must ensure that:

(1) any variable *remuneration*, including a deferred portion, is subject to malus, such that it is paid or vests only if it is sustainable according to the financial situation of the *firm* as a whole, and justified on the basis of the performance of the *firm*, the business unit and the individual concerned; and

(2) any variable *remuneration* is subject to clawback, such that it is not awarded save where it, or an amount corresponding to it, can be recovered from the individual by the *firm* in the 6 years following the date on which the *remuneration* is paid or vests, where the recovery is justified on the basis of the performance of the *firm*, the business unit and the individual concerned.

[Note: article 94(1)(n) of *CRD* and Standards 6 and 9 of the *FSB Compensation Standards*]

19A.3.51A R A *firm* must:

~~(1)~~ ~~ensure that any of the total variable *remuneration* is subject to malus or clawback arrangements;~~ [deleted]

(2) set specific criteria for the application of malus and clawback; and

(3) ensure that the criteria for the application of malus and clawback in particular cover situations where the *employee*:

(a) participated in or was responsible for conduct which resulted in significant losses to the *firm*; or

(b) failed to meet appropriate standards of fitness and propriety.

…

19A.3.52 E (1) …

(1a) A firm should recover vested variable remuneration, or an amount corresponding to it, where, as a minimum, any of the circumstances described in (1)(a), (b) or (c) arise within 6 years following the date on which the remuneration vested.

(2) …

(3) Contravention of (1), (1a) or (2) may be relied on as tending to establish contravention of the *rule* on performance adjustment (*SYSC* 19A.3.51R).

…

19A.3.54 R (1) Subject to (1A) to (3), the *rules* in *SYSC* 19A Annex 1.1R to 1.4R apply in relation to the prohibitions on *Remuneration Code staff* being *remunerated* in the ways specified in:

(a) *SYSC* 19A.3.40 R (guaranteed variable *remuneration*);

(b) *SYSC* 19A.3.49 R (non-deferred variable *remuneration*); ~~and~~

(c) *SYSC* 19A.3.51 R (2) (performance adjustment - clawback); and

(~~c~~d) *SYSC* 19A Annex 1.7R (replacing payments recovered or property transferred).

…

Transitional Provisions and Schedules

SYSC TP 3 Remuneration Code

…			
6B	G	…	
7	R	(1)	Where a *firm* is entitled to amend an agreement entered into on or before 31 December 2014 in a way that enables it to apply clawback to variable remuneration awarded prior to that date in the circumstances provided for in *SYSC* 19A.3.51(2), it must do so at the earliest opportunity.
		(2)	Where such an amendment is not possible, a *firm* must adopt specific and effective arrangements, processes and mechanisms to manage the risks raised by the inability of the firm to apply clawback to the variable remuneration in the way described in *SYSC* 19A.3.51(2).